(4)

No. 87-1513

In the Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION, PETITIONER

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Section 20 of the Glass-Steagall Act, 12 U.S.C. 377, bars bank affiliates from dealing in or underwriting certain types of securities that banks themselves are permitted to deal in or underwrite by Sections 16 and 21 of the Act, 12 U.S.C. (& Supp. IV) 24, 378.

2. Whether the Board of Governors of the Federal Reserve System reasonably determined that Section 20 of the Glass-Steagall Act, which prevents banks from affiliating with firms that are "engaged principally" in certain securities activities, permits banks to affiliate with firms that obtain five to ten per cent of their gross revenues from those securities activities.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-52a) is reported at 839 F.2d 47. The orders of the Board of Governors of the Federal Reserve System (Pet. App. 53a-170a) are reported at 73 Fed. Res. Bull. 473, 607, 616, 618, 620, 622.

JURISDICTION

The judgment of the court of appeals was entered on February 8, 1988. The petition for a writ of certiorari was filed on March 12, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Banking Act of 1933, ch. 89, 48 Stat. 162, contains four provisions, usually referred to collectively as the Glass-Steagall Act (Act), that restrict the participation

of banks and bank affiliates in specified securities activities. See *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207, 216 (1984) (*Schwab*). Section 20 of the Act, the meaning of which is directly at issue in this case, addresses restrictions on bank affiliates; it provides that "no member bank [of the Federal Reserve System] shall be affiliated * * * with any corporation, * * * *engaged principally* in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities" (12 U.S.C. 377 (emphasis added)).

The other provisions of the Act set out limitations in similar terms. Section 16, which imposes restrictions directly on banks, generally prohibits any national bank from underwriting or dealing in securities for its own account, although a proviso to the Section exempts from this prohibition the dealing in or underwriting of specified government securities (so-called "bank-eligible securities"). 12 U.S.C. (& Supp. IV) 24 Seventh.[1] Section 21(a)(1) of the Act forbids investment banking organizations—those organizations "engaged in the business of issuing, underwriting, selling, or distributing" securities—from engaging in the business of banking; as in Section 16, however, a proviso to Section 21 makes it clear that banks may deal in bank-eligible securities. 12 U.S.C. 378(a)(1). Finally, Section 32 of the Act provides that officers, directors, and employees of firms that are "primarily engaged" in securities activities may not at the same time serve as officers, directors, or employees of member banks, unless

[1] The securities exempted from restriction include "obligations of the United States, or general obligations of any State or of any political subdivision thereof," as well as certain types of revenue bonds and mortgage-related securities. The restrictions in Section 16 also apply to state-chartered member banks of the Federal Reserve System. 12 U.S.C. 335.

the Board has approved such overlapping service "by general regulation[ ]" (12 U.S.C. 78).

2. Beginning in 1985, each of the intervenor respondents (the Applicants) applied to the Board under the Bank Holding Company Act of 1956 (the BHCA), 12 U.S.C. 1841 *et seq.*, for permission to engage to a limited extent in underwriting and dealing in certain types of *bank-ineligible* securities—commercial paper, certain revenue bonds, mortgage-related securities, and certain consumer-receivable related securities.[2] The Applicants proposed to conduct this activity through nonbank subsidiaries that were largely engaged in underwriting and dealing in *bank-eligible* securities. See Pet. App. 7a.

On April 30, 1987, the Board conditionally approved three of those applications (Pet. App. 53a-145a),[3] concluding that the proposed activities of the underwriting subsidiaries would not run afoul of Section 20. First, the Board found that bank-eligible securities activities are not implicated by Section 20's prohibition on the affiliation of

[2] The BHCA sets out the federal framework for the supervision and regulation of bank holding companies (companies that have control over one or more banks). The BHCA generally prohibits bank holding companies from engaging, directly or through a subsidiary, in nonbanking activities (12 U.S.C. 1843(a)), but it exempts from that prohibition activities "which the Board * * * has determined (by order or regulations) to be so closely related to banking * * * as to be a proper incident thereto" (12 U.S.C. 1843(c)(8)). Among the factors that the Board must consider in making that determination are whether the activity "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices" (12 U.S.C. 1843(c)(8)).

[3] These involved Applicants Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp. On May 18, 1987, the Board approved similar applications by the other Applicants (Pet. App. 146a-170a).

banks with firms that are engaged principally in the underwriting of "stocks, bonds, debentures, notes, or other securities" (Pet. App. 67a-74a). While noting that, on its face, Section 20 does not distinguish bank-eligible from bank-ineligible securities, the Board reasoned that Congress did not intend Section 20 to foreclose affiliates from engaging in those securities activities that are expressly permitted to member banks by Section 16 (Pet. App. 67a-69a). Citing *Board of Governors* v. *Investment Company Institute* (*ICI II*), 450 U.S. 46, 61 n.26, 64 (1981), the Board also noted that the Act imposes a "less rigorous standard" on member bank affiliates under Section 20 than upon member banks under Section 16, and that " 'a bank affiliate may engage in activities that would be impermissible for the bank itself' " (Pet. App. 68a). The Board therefore concluded that Congress necessarily intended to permit affiliates to engage in such bank-eligible activities without restriction (*ibid.*).

Having established these premises, the Board reasoned that Section 20's prohibition of bank affiliation with entities "engaged principally" in securities activities must be read to bar only affiliations with firms that are engaged principally in *bank-ineligible* securities operations (Pet. App. 74a). Looking to its prior construction of the Act, the Board concluded "that the term 'engaged principally' in section 20 denotes any substantial activity of the affiliate" (*id.* at 76a). In particular, the Board determined that "a member bank affiliate would not be principally engaged substantially in underwriting or dealing activity covered by section 20 if its gross revenue from that activity does not exceed a range of between 5 and 10 per cent of its total gross revenues" (Pet. App. 83a). And looking to the particular applications here, the Board concluded that "the lower 5 percent end of the permissible range of activity under section 20 is the appropriate quantitative level"

for applying its test. The Board recognized that this level "represents a conservative approach to measuring the level of ineligible underwriting," and explained that it "will review this determination, within one year, after Applicants have gained some experience in operating the proposed underwriting subsidiaries" (*id.* at 84a-85a).[4]

3. Petitioner, a trade association representing securities brokers, dealers, and underwriters, petitioned for review of the Board's orders, arguing that the approved activities would violate Section 20 of the Act. After undertaking a comprehensive analysis of the language and legislative history of the Act, the court affirmed the Board's orders in all respects relevant to this petition (Pet. App. 1a-52a).[5]

The court first held that the word "securities" in Section 20 refers only to bank-ineligible securities. The court began its analysis by noting that the word "securities" is

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[4] The Board also made a number of other determinations that are not at issue here. In addition to ruling that bank-ineligible securities activities may not account for more than five to ten per cent of a bank affiliate's gross revenues, the Board concluded that no affiliate's operations may account for more than five to ten per cent of the market for the type of security being placed or underwritten (Pet. App. 80a, 82a). This restriction was not approved by the court of appeals (see note 5, *infra*). The Board also found that underwriting and dealing in bank-ineligible securities is "closely related" to banking within the meaning of Section 4(c)(8) of the BHCA, 12 U.S.C. 1843(c)(8) (Pet. App. 87a-95a), and that the expected public benefits from the authorized activities would outweigh the possible adverse effects (*id.* at 95a-127a).

[5] The court did invalidate the Board's restriction on market share (see note 4, *supra*), holding that "Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activities. A market share limitation simply does not further reduce this congressional worry." The court added that the Board had failed to show "on the record before us that a market share limitation is an objective proxy for a sales volume test" (Pet. App. 50a).

ambiguous, since it is neither defined nor used consistently in the Act (Pet. App. 13a-14a). The court therefore looked to the Act's history and structure to "conclude that construing § 20 as not encompassing activities by bank affiliates in bank-eligible securities is essential if Congress' purpose in enacting § 20 is to be effectuated" (*id.* at 17a). The court explained that the Act was drafted as a compromise between those who advocated a complete separation of the commercial and investment banking industries on the one hand, and, on the other, those who sought to preserve some elements of the existing system of bank affiliates that engaged in securities operations (see *id.* at 26a-31a). Both sides in this debate, the court continued, viewed "Glass-Steagall [as] a means to sever commercial banking only from more speculative, 'perilous' investment activities, in which bank-eligible activities were not included" (*id.* at 30a-31a). The court therefore held that "an interpretation of 'securities' in § 20 that excludes bank-eligible securities from its reach is entirely consistent with Congress' aim" (*id.* at 31a).

The court found support for its conclusion in this Court's decisions construing the Act, which have looked to whether particular bank activities give rise to certain "subtle hazards" associated with dealing in securities. See Pet. App. 34a, citing *Schwab*, 468 U.S. at 220-221; *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137, 154-160 (1984) (*Bankers Trust I*). The court found no such hazards in this case. It noted that Congress, in Section 16, allowed banks to underwrite and deal in bank-eligible securities, "making it plain therefore that [Congress] believed the risks were not so great when banks dealt in these securities" (Pet. App. 35a). And "[s]ince banks are allowed under § 16 to underwrite and deal in government obligations without limitation, it would be incongruous for § 20 to prohibit banks from affiliating with entities

that are merely 'engaged principally' in those same activities" (*ibid.*).

The court of appeals proceeded to uphold the Board's determination that a bank affiliate is "engaged principally" in underwriting bank-ineligible securities within the meaning of Section 20 when those activities constitute a "substantial" portion of its business. The court noted that "[t]he term 'engaged principally' is intrinsically ambiguous" (Pet. App. 39a), and it accordingly chose to defer to the Board's interpretation of the statute (see *id.* at 39a, 41a, 45a). In addition, the court found reasonable the Board's conclusion that an affiliate is substantially engaged in prohibited securities activities when those activities amount to more than five to ten per cent of the affiliate's gross revenues over a two-year period (*id.* at 46a-48a); "[b]ecause of the Board's expertise [the court] also defer[red] to its decision to set the gross revenue limitation at five percent" (*id.* at 48a).

ARGUMENT

As petitioner itself acknowledges (Pet. 10), the question in this case is one of first impression. That question arises in an area that has received considerable attention from Congress in recent years; indeed, legislation that would largely moot this case has passed the Senate and is now pending in the House. And after giving extensive consideration to petitioner's contentions, the Board and the court of appeals gave the question here the only answer that accords with the structure and purposes of existing law. For all of these reasons, further review is not warranted.

1. a. Although petitioner makes a series of empirical assertions (see Pet. 13-15), its central legal contention is the argument (Pet. 17-23) that the word "securities" in Sec-

tion 20 refers to bank-eligible, as well as to bank-ineligible, securities. Petitioner therefore argues that Section 20 bars the affiliation of member banks with firms that are "engaged principally" in activities involving bank-eligible securities. This argument is insupportable.

It is a truism that the Act was adopted because Congress believed that risky securities activities posed a threat to the solvency of banks and thus to bank depositors. See, *e.g.*, *ICI II*, 450 U.S. at 61. In Sections 16 and 21 of the Act, however, Congress expressly provided that banks themselves may deal in bank-eligible securities because, as the court of appeals explained, "underwriting and dealing in [such] securities pose no hazards to banks" (Pet. App. 36a); "the fact that § 16 * * * allows banks to engage directly in * * * [a given activity] suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market" (*Schwab*, 468 U.S. at 221). At the same time, Section 20—by permitting bank affiliation with firms that are not "engaged principally" in securities operations—imposes a "less stringent standard" on affiliates than on banks (*ICI II*, 450 U.S. at 61 n.26), permitting a bank affiliate to engage in securities "activities that would be impermissible for the bank itself" (*id.* at 64).

Since Congress thus undertook the regulation of bank affiliates so as to protect the affiliated banks and their depositors (see generally *ICI II*, 450 U.S. at 61)—and since affiliates otherwise are subject to less extensive regulation than banks under the Act—it would hardly make sense to read Section 20 as prohibiting affiliates from dealing in *bank-eligible* securities. But that is precisely the reading contended for by petitioner. Indeed, under petitioner's approach to Section 20, a bank would be precluded from moving its existing bank-eligible securities underwriting department into a separate, affiliated corporation, even

though the affiliate's only functions would be those currently being conducted by the bank. We cannot imagine—and petitioner does not suggest—any rationale for this result.

b. Petitioner nevertheless contends (Pet. 17-21) that its reading is compelled by the plain language of Section 20; in making this argument, petitioner notes that Section 20 refers generally to "securities" and does not contain the exception for bank-eligible securities that is written into Sections 16 and 21. As the court of appeals correctly explained, however, Congress's use of the word "securities" is not free of ambiguity. The original version of the Act referred to securities in three different ways: Section 16 distinguished bank-ineligible from bank-eligible securities; Sections 20 and 32 (as well as the original version of Section 21) referred to "securities" in general terms; and a since-repealed Section 19(e) referred to "securities *of any sort*" (12 U.S.C. (1964 ed.) 61(e) (emphasis added), *repealed, by* Act of July 1, 1966, Pub. L. No. 89-485, § 13(c), 80 Stat. 242-243). "That Congress chose three distinctively different ways to describe securities raises a red flag that cautions against declaring that the meaning of that term in § 20 is clear" (Pet. App. 14a). In addition, in 1935, two years after the adoption of the Act, Congress amended Section 21 to add the existing proviso authorizing banks to conduct bank-eligible securities activities. At the time, however, Congress made clear that it was simply clarifying what the phrase "stocks, bonds, debentures, notes, or other securities"—the same phrase that appears in Section 20—had meant from the beginning.[6] See S. Rep. 1260, 73d Cong., 2d Sess. 2 (1934); S. Rep.

[6] There was a particular need for legislative clarification of Section 21; it is a criminal provision that the Board declined to interpret authoritatively. See 20 Fed. Res. Bull. 543-544 (1934).

1007, 74th Cong., 1st Sess. 15 (1935); H.R. Rep. 742, 74th Cong., 1st Sess. 16 (1935); *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052, 1058 (D.C. Cir. 1986), cert. denied, No. 86-1429 (June 19, 1987).[7]

In these circumstances, where the meaning of the statute is debatable, deference to the Board's construction is appropriate.[8] See, *e.g., Schwab*, 468 U.S. at 217; *ICI II*, 450 U.S. at 56; *Board of Governors* v. *Agnew*, 329 U.S. 441,

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[7] In arguing that the meaning of Section 20 is plain, petitioner relies (Pet. 18-20) principally on two of this Court's decisions, *Bankers Trust I* and *Board of Governors* v. *Dimension Financial Corp.*, 474 U.S. 361 (1986). Neither is relevant here. In *Bankers Trust I*, the Court examined the language (see 468 U.S. at 148-154) and purposes (see *id.* at 154-159) of the Act en route to concluding that commercial paper is a "security" within the meaning of Sections 16 and 21. The Court had no occasion to, and did not, address the relationship between the restrictions imposed on banks by those provisions and the restrictions imposed on bank affiliates by Section 20. *Dimension* held only that certain institutions are "banks" within the definition of that word set out in the BHCA. That holding – which involved a term that, in contrast to the one at issue here, is given an express definition in the applicable statute – plainly has no bearing on this case.

[8] Despite petitioner's hint to the contrary (Pet. 10-11), this Court has generally declined to review appellate decisions upholding reasonable agency interpretations of the Act. See *e.g., Securities Industry Ass'n* v. *Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987), cert. denied, No. 87-562 (Jan. 11, 1988); *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), cert. denied, No. 86-1429 (June 19, 1987); *Investment Company Institute* v. *FDIC*, 815 F.2d 1540 (D.C. Cir. 1987), cert. denied, No. 87-36 (Oct. 5, 1987); *Investment Company Institute* v. *Conover*, 790 F.2d 925 (D.C. Cir. 1986), cert. denied, 479 U.S. 939 (1986); *Investment Company Institute* v. *Clarke*, 793 F.2d 220 (9th Cir. 1986), cert. denied, 479 U.S. 939 (1986); *Investment Company Institute* v. *Clarke*, 789 F.2d 175 (2d Cir.), cert. denied, 479 U.S. 940 (1986); *Securities Industry Ass'n* v. *Comptroller of the Currency*, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986), rev'd on other grounds, 479 U.S. 388 (1987).

450 (1947) (Rutledge, J., concurring). See generally *FDIC* v. *Philadelphia Gear Corp.*, 476 U.S. 426, 431 (1986). That is particularly true here, where the Board's lengthy orders—issued after a public hearing on the proposals—gave extensive consideration to petitioner's contentions, and where the Board's conclusion is entirely consistent with its longstanding view that bank holding companies may control nonbank subsidiaries that are engaged exclusively (and thus, necessarily, principally) in bank-eligible securities activities. See 12 C.F.R. 225.25(b)(16); *United Bancorp*, 64 Fed. Res. Bull. 222 (1978); *United Oklahoma Bankshares, Inc.*, 65 Fed. Res. Bull. 363 (1979); *Citicorp*, 68 Fed. Res. Bull. 249 (1982).[9]

[9] Petitioner contends (Pet. 21-23) that the Board's ruling here is inconsistent with its approach to Section 32, the provision of the Act that bars personnel interlocks between banks and firms that are "primarily engaged" in securities activities, "except in limited classes of cases in which the Board * * * may allow such service by general regulations." Because the Board believed in 1934 that it had to create an exception under Section 32 to permit interlocks between member banks and firms engaged in the distribution of bank-eligible securities, petitioner maintains that the Board must also have believed that the plain language of Section 20 applied to firms engaged in the bank-eligible securities business (Pet. 22, citing 20 Fed. Res. Bull. 485 (1934)). The point that is important for present purposes, however, is that—whatever its stated rationale—the Board has never treated bank-eligible securities operations as subject to the substantive restrictions of Section 32. Accordingly, the Board should not here be locked by analogy into a rationale it expressed more than 50 years ago in a very different context. As the courts have noted, in the Depression era regulators often took "an overcautious approach to bank regulation reflecting the atmosphere of the years immediately after the 1929 market crash." *New York Stock Exchange, Inc.* v. *Smith*, 404 F. Supp. 1091, 1097 (D.D.C. 1975), vacated on other grounds, 562 F.2d 736 (D.C. Cir. 1977), cert. denied, 435 U.S. 942 (1978). See *Securities Industry Ass'n* v. *Comptroller of the Currency*, 577 F. Supp. 252, 255 (D.D.C. 1983), aff'd, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986).

2. Petitioner also (Pet. 23-24) takes issue with the holding below that a firm would not be "engaged principally" in securities activities when those activities do not exceed five to ten per cent of the firm's revenues. Petitioner appears to contend that any activity in which the firm engages "regularly" (Pet. 23) should be viewed as the firm's "principal[ ]" activity within the meaning of Section 20—even if that activity constitutes a wholly trivial proportion of the firm's business. But this assertion is flatly inconsistent with the language of Section 20, which makes it plain that bank affiliates may conduct bank-inelegible securities activities at some level. See *ICI II*, 450 U.S. at 64. Petitioner's real contention is that banks should not be permitted to affiliate at all with entities that engage to any extent in the securities business (see Pet. 11-15). As the court of appeals explained, however (Pet. App. 26a-27a), Congress rejected that approach when it worked the compromise that emerged in the Act, which limits, rather than eliminates, bank securities affiliates. See S. Rep. 77, 73d Cong., 1st Sess. 10 (1933).

Similarly without merit is petitioner's contention (Pet. 15-17, 23-24) that the Board adopted an improper " 'regulatory approach' " to the Act in its rulings in this case. It is true, of course, that the Board may not substitute a permissive regulation for a statutory prohibition. See *Bankers Trust I*, 468 U.S. at 153-154. But petitioner has offered no reason to believe that the Board acted improperly in setting a quantitative standard when it interpreted the inherently imprecise phrase "engaged principally." As the court below noted, "[t]he mere necessity of 'regulation' in carrying out Glass-Steagall's 'prohibitions' is insufficient to justify rejection of an otherwise reasonable interpretation of the Act" (Pet. App. 45a). "The Glass-Steagall Act does impose a system of flat 'prohibitions' and 'prophylactic' measures, * * * but this can-

not obviate the need to examine particular factual situations to determine on which side of the prohibitory line they fall." *Securities Industry Ass'n* v. *Board of Governors*, 807 F.2d at 1067.[10]

3. Finally, petitioner is incorrect in asserting (Pet. 16-17) that the Board's decision somehow displaces Congress in setting banking policy. Congress last year adopted legislation suspending the effective date of the Board's decision in this case until March 1, 1988 (Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, §§ 201(b)(2)(A), 203, 100 Stat. 581-582, 584); although Congress plainly was aware of the consequences, it has since allowed that moratorium to expire. Indeed, Congress is now considering legislation that would grant banks broad, new securities powers. On March 30, 1988, the Senate, by a vote of 94-2, passed a bill that (among other things) would repeal Section 20, the statutory provision whose meaning is disputed by petitioner. 134 Cong. Rec. S3437 (daily ed. Mar. 30, 1988).[11] The appropriate committees in the House are now considering similar bills. In these circumstances, it is petitioner's attempt to involve the Court in this case, and not the Board's decision, that threatens to interfere with Congress's legislative activities.

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[10] The particular regulatory restrictions attacked by petitioner (Pet. 23-24) were in fact adopted under the BHCA, not under the Act, as petitioner implies.

[11] The bill would permit bank affiliates to underwrite all bank-ineligible securities, except corporate stock, without regard to the existing "engaged principally" limitation.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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